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CURRENCIES AND CREDIT MARKETS

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"[...] but one thing is certain, that at particular times a great deal of stupid people have a great deal of stupid money... At intervals, from causes which are not to the present purpose, the money of these people — the blind capital as we call it, of the country — is particularly large and craving; it seeks for someone to devour it, and there is a 'plethora'; it finds someone, and there is 'speculation'; it is devoured, and there is 'panic'."

Walter Bagehot, "Essay on Edward Gibbon'.

HIGHLIGHTS

There's no denying that the U.S. monetary aggregates refuse to follow the chorus of recovery forecasts. Indeed, if money matters, current monetary trends not only rule out any economic recovery, but actually signal a deepening U.S. recession.

The key to understanding the present monetary and economic situation in the United States is found in credit developments and as such is reflected in the near-collapse of private borrowing.

Three strategic factors buttress our opinion that no sustainable economic recovery is in prospect: secularly-low business profits, sagging real estate prices, and unevenly-spread high debt levels.

If the U.S recovery fails to materialize, it will trigger a psychological shock to businesses, stock markets and currencies world-wide. However, we are less concerned about Continental Europe, even though a slowing of economic growth is inevitable.

The present recession of the U.S. (as well as the other Anglo-Saxon countries) is of a totally different class than that of the all the other post-war recessions. In terms of the complex of causes, it's more comparable to the Great Depression.

We present a broad comparison of the financial, economic and psychological aspects of 1930 with those prevailing in 1991.

The similarities do not necessarily imply plunges in output and employment as occurred in the 1930s. Taking a global perspective, we identify three positive differences that today have stabilizing influences that didn't come into play during the 1930s.

We also point to several differences that have much worse implications for financial markets and economies today. The most critical parallels between 1929-1930 and today are psychology, complacency, expectations and dominating policy perceptions. The similarities are striking.

The days of the speculative global bond wave are numbered. Yield spreads vis-a-vis DM bond are at unusual levels. That leaves little doubt where the next action will be — German bunds.

If the United States continues to lower interest rates, as seems probable, it implies a progressive strengthening of the D-Mark. In drastic contrast to the consensus view, in due time, we expect the dollar to fall towards new all-time lows against European currencies.

1991 VERSUS 1930: COMPLACENCY WITHOUT COMPARISON

While most economists are happily engaged in their pursuit of finding comforting comparisons with past cyclical recessions, our focus continues to be driven by the important and critical differences — namely, the unique causes of the present U.S. recession.

These unique causes, in turn, are now giving way to unique symptoms. Recently, the U.S. Fed engineered its 17th cut of the federal funds rate in 27 months. It was the second easing within five weeks, an unusually short time span for such a long-range policy tool. What was the prime reason that was cited by the Fed for its recent discount-rate cut? Unusually low money growth.

In complete defiance of the progressive monetary easing, the money picture tends to slip from bad to worse. Both M2 and M3 have contracted over the last three months for the first time on record. M2 has increased only 2.2% year-over-year, which is the smallest gain since the early 1960s when inflation was running at only 2.1%. Year-over-year growth in M3 and M4 has fallen to barely 1%, also the lowest rate of expansion on record. No wonder markets are therefore already speculating on the next monetary easing and think it's a foregone conclusion.

There's no way of getting away from the fact that the monetary aggregates refuse to follow the chorus of recovery forecasts. Indeed, if money matters, current trends not only rule out any economic recovery, but actually signal a deepening recession.

THREE COMFORTING EXPLANATIONS . . .

Does money matter? Understandably, the perpetual bulls are at pains to ferret out explanations for this extraordinary monetary sluggishness that would still allow them to stick to their rosy forecasts.

The favourite and most widely accepted explanation for the disturbing money picture is that it's a distortion caused by the massive portfolio shifts of investors switching from low-yielding bank deposits and money market funds (components of the money stock) to equities and higher-yielding alternatives such as bonds and mutual bond funds (which are not). The implied conclusion is that these shifts lower the measure of money supply without actually reducing liquid balances available for spending. Therefore, there's little to worry about.

A second interesting explanation — though totally different — has recently been advanced by the Bank Credit Analyst. Similarly, they conclude that the *"contraction in the banking system is not expected to impede an economic recovery significantly."* Their viewpoint rests on two main arguments: firstly, that banks account for a shrinking share of credit creation; and secondly, that credit weakness signifies more a lack of demand rather than bank restraint.

Others have found consolation in the fact that the narrowly defined money measure of M1 has continued to expand at a "healthy" 7% annual rate. The argument here is that M1 is the crucial component of the total money supply, and since it mostly consists of true transaction balances, that it therefore is the one to watch.

Meanwhile, it is reported that the Fed has been unable to find an adequate explanation for why money-supply growth has been so slow and is now concerned. In a recent statement to Congress, Mr. Greenspan stressed the key role of M2 as a guide for policy based on the fact that ". .. *since the founding*

of the Federal Reserve, nominal GNP and M2 have grown, on average, at almost precisely the same rate." Ergo, the lower the growth rate of M2, the higher the worry for GNP.

MONEY PROBLEMS ARE CREDIT PROBLEMS

If the narrow money aggregate M1 seems to be booming while the broader aggregates are virtually collapsing, is there any other statistic that we can focus on to find a clearer picture? In short, the main aggregate to watch is credit growth . . . more precisely, credit flows to the private sector.

Some time ago we opined that American economists know everything about money supply except how it is created and destroyed. The Fed's recent consternation and Wall Street's imaginative theories confirm that opinion. A small primer on the creation of money supply is in order.

Money growth critically depends on credit creation. Falling money growth essentially results from declining credit expansion — particularly, private credit expansion which primarily takes place through bank loans and commercial paper. Private credit growth is therefore highly correlated to the trend in broad money. Public borrowing, by contrast, is primarily directed to the securities markets — new issues of treasury bonds, for example.

It is in the area of private credit that the biggest and cataclysmic changes are taking place. It also lies at the root of the recessions in all of the English-speaking countries — the United States, Britain, Canada and Australia. All have experienced their steepest and most protracted declines in private-sector credit growth since the Great Depression.

In the United States, private non-financial debt growth has tumbled from an annual rate of 9.5% in 1988 (and over 13% in 1984-85) to the present emaciated pace of 3%. In Britain it has fallen from 25% growth in 1988 to 6% recently; in Canada from 13% to 3.7%; in Australia from 24% to virtually zero.

In the United States (also Canada), the collapsing growth of private credit coincides with soaring public credit. Over the past year, private debt grew $218 billion, while government debt grew $297 billion. In 1988 — that being before the start of the economic slowdown — private debt rose $603 billion while Treasury debt only grew $157 billion. As can be seen, what's happened in the interim is that total annual new borrowing on the part of consumers and corporations has plummeted by almost $400 billion or 7% of GNP.

. . . EXPLANATIONS WHICH ALL MISS THE POINT

No doubt, portfolio shifts are taking place which have the effect of reducing the money stock. What the apologists fail to mention, however, is that this so-called disintermediation process is the regular, normal monetary pattern of the business cycle when short-term interest rates tumble below long-term interest rates. So what's different this time? It's the fact that money growth is at an all-time low in the context of this normal phase. That's our point to start with.

Furthermore, the asset shift isn't extraordinary in size. To July of this year, stock and bond funds recorded combined net inflows of $55 billion. That compares to a figure of $33 billion during the same period of last year and, as such, signifies nothing far out of the regular. On the other hand, one also must recognize that the commercial banks have been heavily adding to the money supply through their

large net purchases of government bonds — $60 billion over the past year and $46 billion during the first seven months of 1991. That, too, is typical for this particular phase in the business cycle.

Clearly, the "portfolio shift" theory is grossly inadequate. What's worse, it diverts attention from the true fundamental cause.

All things considered, the salient point to see is that this monetary weakness is exceptional. The next important aspect to see is the link between credit and GNP growth. Corporations and consumers mostly borrow money in order to buy either goods or services; these being counted as the current output of the economy. Yet, this link between credit and GNP growth isn't perfect because money may be spent on such other things as imported goods or on the purchase of existing financial or real assets which are not part of current-year GNP. (Remember the runaway takeover frenzy that played such a dominant role in the 1980s?) While the purchase of existing assets doesn't directly spur GNP growth, it may well have by indirectly lifting consumer spending through the "wealth effect" of inflated asset prices.

New government borrowing, presently, as opposed to private borrowing, is used for spending that has very little or no impact on GNP at all. That happens when government spending on such things as interest charges and the S&L bailout outpaces new government borrowing. This type of spending doesn't impact GNP very much. In technical jargon, public borrowing and spending has a low multiplier effect on the economy.

What's worse is that the ballooning public deficits tend to keep long-term interest rates higher and the economy weaker than would otherwise be the case. These distinctions between the public and the private sector uses of credit and money and their respective impact on GNP are of utmost importance in the current "slow-money-growth" saga.

In conclusion, the key to understanding the present monetary and economic situation in the United States is found in credit developments and as such is reflected in the near-collapse of private borrowing. Watch credit, in particular, private credit — and forget about portfolio shifts. Credit aggregates have an advantage in that they are not affected by purely financial distortions.

The safest forecast to make at this point is that any sustained recovery implicity depends on new credit creation in the private sector.

CAUSES AND EFFECTS — THE GREAT PUZZLE

Why is there a persistent disruption in the flow of credit to the private sector? Who is responsible? Is it the lenders or the borrowers? Is it primarily a cause of falling credit supply or falling credit demand?

Anecdotal evidence suggests that the causes lie on both sides of the equation. Lenders — the banks, S&L's, insurance companies — have clearly become more restrictive since they are hampered with bad loans and capital insufficiencies; corporations are struggling with record-low profit margins, shrinking cash flows and overindebtedness while consumers are juggling with an oppressive mix of falling real incomes, rising taxes and overhanging debt burdens. There is no simple or single cause. It's a highly complex brew in which many variables interact in a cumulative self-reinforcing manner, everything being as much an effect as a cause.

THE MOST IMPORTANT DIFFERENCES

Most economists soothingly like to point out that the "average" post-war recession has lasted eleven months. On this basis, then, the recovery can be expected to rebound in earnest by the fourth quarter of this year at the latest.

But, what does the "average" apple have to do with an orange? Any recovery forecast for the U.S. has to start with the recognition that the present U.S. recession is fundamentally different from the type reflected in the average of the postwar recessions. The latter were all triggered by tight money. Once this money shackle was removed, the economy always jump-started spontaneously. Consequently, fluctuations in GNP output mainly reflected a sharp but brief inventory cycle. Inventory liquidations followed by restocking caused self-correcting downturns to ripple through the economy.

The present recession, however, is of a totally different class. In terms of the complex of causes, it's more closely comparable with the Great Depression. We hasten to add, though, that the similarity of causes does not therefore necessarily imply similar plunges in output and employment as occurred in the 1930s. Taking a global perspective, we identify three main positive differences between the 1930s and today.

TODAY'S THREE STABILIZERS . . .

A main, crucially-important difference between today and the 1920-1930s is the role of exports. In 1929-32, a steep fall in U.S. exports of about 60% greatly deepened the domestic depression. Contrastingly, strong exports over the last two years have played a leading role in softening the severity of the U.S. recession, particularly cushioning the manufacturing sector which exports about 22% of its output.

A second difference today is the absence of a disastrous agricultural depression such as occurred in the 1930s.

The third important difference is the size of the public sector. In 1929-30, government spending accounted for only 3-4% of U.S. GNP, while today, it's about ten times as much. While a big public sector has many negative effects, there is no denying that it acts as a stabiliser of incomes.

While these three differences may have a stabilizing effect, there are also some elements that make for worse comparisons.

. . . OVERSHADOWED BY TODAY'S THREE BIG NEGATIVES

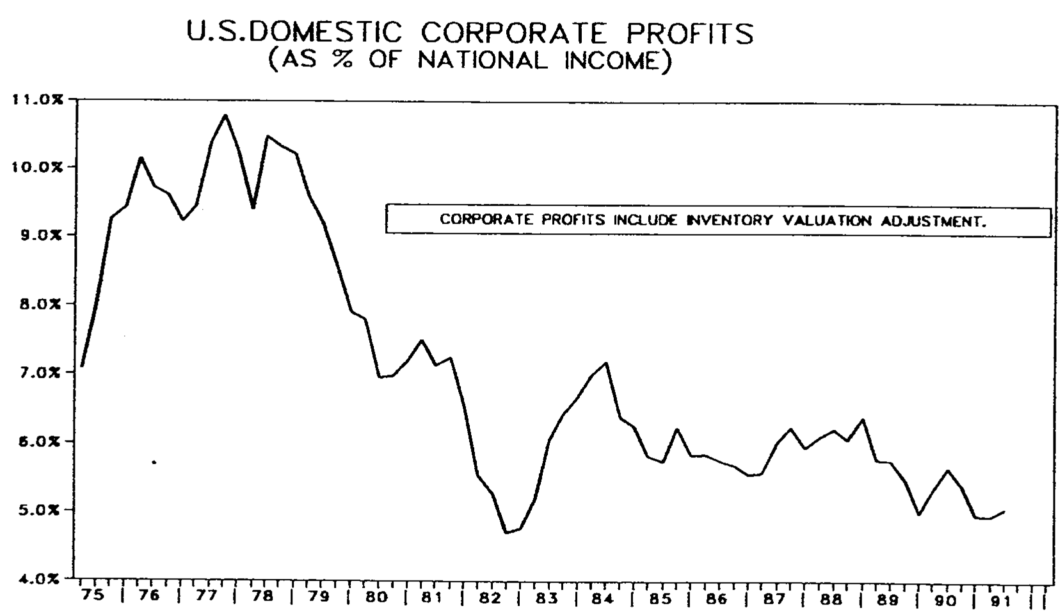
Firstly, on the negative side is the U.S. international position. In the 1920s, the U.S. economy experienced large current-account surpluses which facilitated its role as the world's leading creditor country. Now, conversely, America has enormous deficits.

Of crucial importance, a second negative difference pertains to the capital sphere — investment spending, productivity growth and profit conditions. During the 1920s, capital formation (investment and capital spending) corresponded to a level of about 10% of GNP. Business profits grew roughly in line with the rapid rise of GNP and remained around a level of 10% of national income. By contrast, the 1980s, as is well known, have been an outright disaster . . . a profitless prosperity. (Please, see the chart below).

Net capital formation barely crawled at a pace of 2-3% of GNP, and productivity growth, returns on capital, and profit margins have all fallen to post-war record lows.

That brings us to the third trouble spot — the stock market and stock prices relative to business earnings. In the 1920s, the stock market boom was underpinned by a steady rise in earnings while in the 1980s, U.S stocks skyrocketed in sheer defiance of collapsing business profits. The price-earnings ratio for the Dow Jones industrials rose to a high of 16.2X in January of 1929 and was 13.5X by September of that year, the time-point at which the market finally peaked.

Noteworthy is the fact that the 1929 P/E multiples co-existed with much lower long-term interest rates — around 4% or so. Was the 1920's stock market really such a speculative orgy? By historical comparison at the time, yes. The more traditional P/E ratio had been more like 10X. However, compared with the stock market mania of the 1980s, the so-called orgy of the 1920s was more like a society tea party.



Source: U.S. Department of Commerce, Hahn Capital Partners Inc.

As we write, the P/E ratio for the S&P 500 is near 20X and it's above 23X for the Dow Jones Industrials. By this measure, given the prospect of a lacklustre earnings recoveries, the present stock market mania by far beats that of the speculative late-1920s.

THE DANGEROUS PARALLELS

The list of the 1920's parallels is short but awesome.

The similarities begin with the ill-structured peculiarities of the preceding boom times. The boom of the 1920s, just as the boom of the 1980s, was driven by a runaway credit and debt inflation. Both periods

in the United States ended with record-high corporate and private household debt.

The second parallel is that the borrowing binge was overwhelmingly applied to the financing of consumption, financial speculation and leveraging. Another common area of overexpansion and overspeculation was real estate — particularly commercial real estate. GNP growth, moreover, was heavily skewed to services and construction in both cases. Manufacturing employment was no higher in 1929 than in 1919. Today, manufacturing employment is almost 3 million lower or 15% less than in 1979.

The history books present the 1929 stock-market crash as the dividing line between unbounded optimism and the onset of equally contagious pessimism. In reality, the high-riding expectations which had built up such a head of steam during the 1920s were not cooled so quickly. Quite to the contrary.

Between November 14, 1929 and mid-April of 1930 — a period of four and a half months — the stock market recovered about half of its 1929 decline. It seemed as though the "Black Monday" crash had come an gone without any ill omen. After all, there had been declines of even greater magnitude in 1924 and in 1926-27.

THE TRUE ROLE OF THE FED

How, in fact, did the Fed react to the crash? The actions of the central bank have been greatly misinterpreted down through the decades. The fact is that the Fed slashed its discount rate twice in November of 1929 and then another four times before June of 1930 and in the process dropped the bench-mark rate from 6% (August 1929) to 2.5%. Simultaneously, the Fed also boosted its holding of government securities from $136 million to $511 million between October 23 and December 31 of 1929.

Objectively, that was pretty dramatic action. The only problem was that it had no visible effect. The commercial banks continued to retrench and decreased their discounts at the Fed. In hindsight, it was to be asserted that the Fed had not moved far and fast enough and that more aggressive action would have saved the day.

The question here, though, is one of foresight not hindsight. It's easy to blame the Fed afterwards in full knowledge of what happened later. But, contemporary observers did not and could not see any cause for concern. Why? One reason was that the economy looked fundamentally sound and strong; to that point, business profits had been excellent. A second reason was simply that what was to follow — the subsequent economic and financial collapse — was completely outside the realm of historical experience.

Prominently, the mere absence of inflation gave rise to the accepted idea that economic conditions were thoroughly healthy. Consumer prices were no higher than in 1922. Money supply didn't decline significantly until March of 1931. Overall, no cautionary signs were obviously visible. For people and policy-makers alike, there seemed to be many good reasons for optimism.

The following extract from a report by the League of Nations, <u>The Course and Phases of the World Economic Depression, 1931</u> captures some of the situation and the prevailing psychology:
"At the turn of the year, 1929-30, there was a tendency in financial and business circles, particularly in the United States, to take an optimistic view of the situation and to assume that the depression would be of short duration; there was even an improvement in the United States which went above the normal

seasonal pattern . . . In the beginning of 1931, the course of events of the preceding year was to a large extent repeated . . . Pessimism became less acute and speculative shares rose rapidly on the stock markets. In many quarters hopes were nourished that this improvement was the beginning of a real recovery. These hopes were, however, not justified. In May, the situation somewhat suddenly changed for the worse . . .

Economists could never agree on the ultimate cause(s) of the Great Depression. It was customary to lay the main blame first on the orgy of speculation of the 1920s; later on the stupidity of central bankers and government officials. Instead of applying the expansionary monetary and fiscal policies which later generations of economist considered to be an infallible cure-all, the authorities allegedly consigned their economies to certain death by deflation, supposedly induced by excessively tight money and increases in taxes. As a result, President Hoover of the United States and the German Chancellor Bruning gained celebrity status in the history books as arch-deflationists.

That brings us to what we consider to be the most important parallels and contrasts between the situation of 1929 and today: psychology, complacency, expectations and dominating policy perceptions — all of which have seemed to escape any widespread attention.

PARALLELS IN COMPLACENCY

As already explained, for most economists and people, the prevailing hope of "recovery just around the corner" was mainly justified by the absence of inflation. They were to be proven terribly wrong. It's a crucial deception. This the time it isn't a "zero inflation" rate but rather falling inflation that is hailed as the magic cure-all with the same naivety.

Secondly, how do the fiscal and monetary policies of the two periods compare? The differences that we see are mainly to the negative. Remember that Germany's chancellor Bruning was generally ridiculed by later generations of economists for raising taxes in the midst of depression. Today, one government after another is doing the same thing since their public-sector budgets were already out of control before the onset of recession.

As for the monetary policies, only time will tell whether or not central banks will be better able to prevent a deepening recession this time. So far, we are awe-struck by the picture-perfect replay in rhetoric and psychology. Then, governments and central banks tended to justify restrictive measures even in the midst of recession citing the need to build confidence. Today, the catchword is credibility.

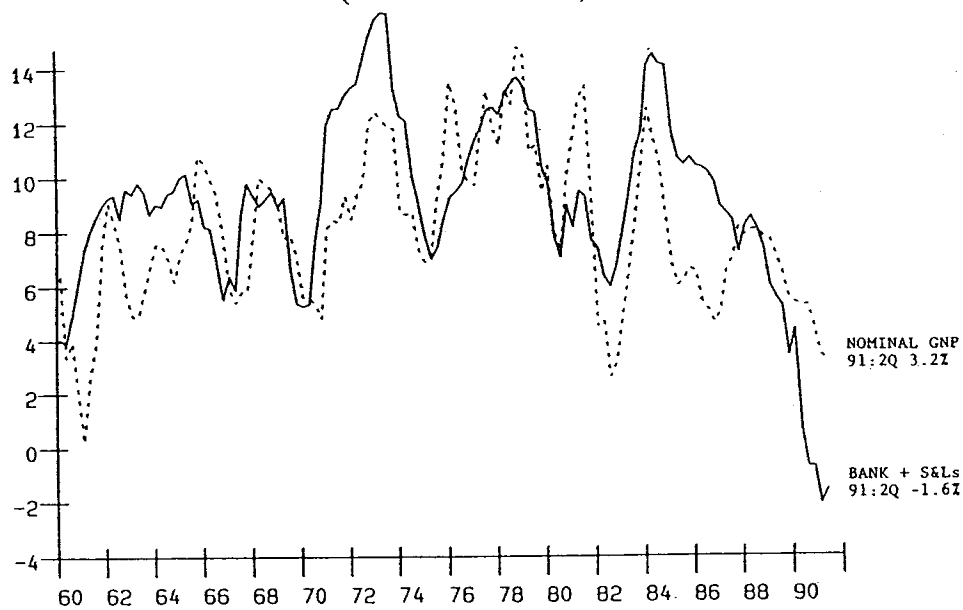
We hasten to add, though, that we have much greater sympathy for the complacency of 1929-30 than today. In most respects, as we already pointed out, the economy was in truly excellent condition then. For many years, inflation had been near-zero, foreign trade was in surplus, the government budget was in balance, and businesses enjoyed healthy profits.

True, there was the infamous banking crisis. As explained in the last letter, we regard the present financial crisis as being far more pervasive. Back then, it was confined to a large number of mini-commercial banks with a very minor volume of deposits, while insurance companies emerged as bastions of liquidity. Now, the biggest banks are among the weakest, and virtually every financial sector is vulnerable.

With the benefit of hindsight, we know that the bank failure in the 1930s had two main effects: it dealt a shock to confidence and reduced money supply. Milton Friedman had argued that the banking failures were a chief cause of the Depression because it was the mechanism which produced the decline in the money supply. The psychological effect, though, didn't interest him very much.

Today, nobody is the least bit concerned about the S&L and bank failures which involves hundreds of billions of dollars. The argument for complacency now is that the bail-outs are self-financing. We've kept an eagle eye on the balance sheets of both groups of depository institutions. What we see is an unprecedented asset contraction that beats anything in the post-war period and even exceeds that of 1930. Just take a look at the contraction evident in the following chart.

BANK AND S&L FINANCIAL ASSETS VS. NOMINAL GNP
(YEAR-TO-YEAR)



Source: International Strategy and Investment, Weekly Money Report, September 23, 1991

Today, undoubtedly, America confronts far bigger and more looming problems. Just about every parameter of comparison is more negative. Apart from the banking and debt problems, there is the spectre of the largest U.S. budget deficit in history, forcing the Treasury to borrow at an unprecedented pace. And there are other problems: a large chronic trade deficit and declining real wages concurrent with record-low business profits — all the while that the Dow Jones P/E multiple levitates far above that of 1929.

So much about the parallels and contrasts between "then" and "now." We'll come back to a few more comparisons in future letters.

SEARCHING FOR THE TRIGGER

It's conventional wisdom that the severity and length of any recession or depression depends basically on the magnitude of the maladjustments and excesses which developed during the preceding boom. From

the vantage point of 1950-1960s, people viewed the 1920s as a period of extraordinary excesses, mainly being symbolized by a rampant blow-off in stocks and real estate prices. They had no idea, of course, of the excesses that were yet to follow during the 1980s.

Eying the present situation in the U.S. two critical questions come to mind: What was it really that triggered the U.S. economy's downturn in 1929-30 and why did it then degenerate into the cumulative, self-reinforcing deflation and depression?

Actually, there was no outstanding event in 1930 — the great mythical black toggle-switch — that might be considered as the watershed event that launched the economic avalanche that started later that year. As we already pointed out, earlier in the year the business community was fairly optimistic. Mirroring the sentiment, Business Week gave eight reasons supporting a business upturn including a rapid credit expansion, low inventories, low prices for imported commodities, and good prospects for auto sales in the fall. Last but not least, everybody trusted in the stimulative effects of interest rates which had fallen to extremely low levels. In short, the mind-set was pretty much as today.

It was not until a year after the stock market crash, in the fall of 1930, that the realization hit that business was not recovering. Instead, confidence in future business and employment prospects evaporated and the downturn began to gather momentum. That triggered the legendary, cumulative spending cuts on the part of both consumers and corporations. Joseph Schumpeter expressed the degree of surprise with this famous metaphor: *"People, for the most part, stood their ground firmly. But that ground was about to give way."*

All of the above again re-emphasizes the key role of psychology and expectations — something we regard as being critically important. There was a vast discrepancy between economic reality and perception in 1930. There is exactly that same kind of discrepancy today . . . in fact, it's even greater . . . far greater. It's exactly that discrepancy that adds the element of great danger.

Today, just as in 1930, the average person in the street feels and knows that the current situation is bad and increasingly difficult. But, hope springs eternal as far as the future is concerned. Unknown in the 1930s, this time various confidence surveys are available that precisely show this same dichotomy of perception. From a year ago September, the Conference Board Consumer Index gauging the current situation has plunged from 97.5 to 39.3. On the other hand, the Consumer Index measuring expectations over the next six months has only declined to a level of 95. Yes, like 1930, there is today a similar decoupling from reality.

The uppermost question in our mind, then, is exactly what thing or event will puncture the psychological helium balloon of 1991? True, some sobering is already taking place. Most recent economic data has been disappointing relative to the high-riding expectations. Weak money and employment numbers are a few key examples. Yet, it's also true that few in the financial world are truly pessimistic; most are straining to find the silver linings in hope that a recovery is only postponed and not aborted. An army of analysts and economists stand ready to translate the worst numerical data into the best verbal opiate.

THE FACTORS OF STRATEGIC IMPORTANCE

The more we study the trends of U.S. economic, financial and monetary fundamentals, the more we are convinced that the recession can only deepen. Three factors of strategic importance underlie that

assertion: firstly, business profits; secondly, sagging real estate prices and its impact on collateral values; and thirdly, unevenly spread and high debt levels.

Circumventing the thicket of statistics to prove our point in this letter (we've done that many times in previous letters) we conclude that the present recession in the Anglo-Saxon countries has three interacting key causes: a profit deflation translating into an income deflation, a real estate deflation translating into a credit crunch, and excessive debt levels forcing corporations and consumers to deleverage again.

Sizing up the trends in these three strategic elements, we see nothing but a continuing deterioration. Everyone's efforts to liquefy their own balance sheet by either cutting expenditures or lopping off assets only serves to heighten the pressure on incomes and asset values. The only thing that can break this vicious circle of self-reinforcing contraction would be a massive credit and money creation by the banking system that would successfully boost spending, profits, incomes and asset prices. Instead, banks, too, are retrenching because they are caught in the down draft of asset price deflation. Once in progress, such a self-deflation become unstoppable until the maladjustments are all liquidated.

Conventional wisdom holds that all that's required to trigger such a new credit wave is even lower interest rates. But, there are two snags to this view. For one, ballooning budget deficits are holding long-term interest rates relatively high. Another problem is that if business profits fall faster than interest rates, there is no stimulative effect and no demand for credit.

Actually, interest-rate cuts, the Gulf War victory, and the drop in oil prices did release a powerful stimulative effect . . . on expectations, forecasts and the bond and stock markets. Without a doubt, the resulting surge in confidence gave significant short-term support to the economy, too, though not enough for a real recovery.

CONCLUSIONS

In recent weeks, sentiment has definitely changed. Expectations are falling. Most recognize the economy's failure to respond to the Fed's past monetary easings. Yet, unflinchingly, people remain becalmed by their deep-down conviction that the Fed will do "whatever is necessary" to stimulate the economy out of recession. Few sense any greater danger.

Globally, the dominating perception still is that the Anglo-Saxon economies will recover from recession and lead a world rebound. That notion is still providing strong support for their stock markets as well as those abroad and their currencies. If the U.S recovery fails to materialize, it will trigger a psychological shock to businesses, stock markets and currencies world-wide.

The world economy will surely weaken without a sustained recovery in the Anglo-Saxon countries. However, in contrast to the consensus view, we are less concerned about Continental Europe than normally might be the case since important differences are at play today. A major reason is that the Continent has experienced an unusually sound and balanced expansion without the debt and real estate excesses of the Anglo-Saxon countries. All the same, the European economies — including Germany — are bound to weaken.

So much for the broad economic picture. What about prospects for the financial markets? Over the past few months, steep declines in short-term interest rates and declining inflation have triggered a massive

global speculation in the bonds of the higher-yielding recession countries with favourable effects on stock markets as well.

It was always clear that the really critical period for the debtor countries would begin when domestic and foreign credit dries up. Historically, so long as the flow of domestic and foreign credit remained abundant, the cracks in the economic and financial structure were concealed, creating an illusion of soundness and stability. But, the tide has turned. Rampant credit inflation is inevitably followed by a protracted credit and debt deflation which squeezes business profits, consumer incomes and asset prices.

Handsome profits have been reaped, but the days of the speculative global bond wave are numbered. Yield spreads — vis-a-vis DM bonds — have shrunk to unusual lows (and negative spreads against U.S. long-term rates.) That leaves little doubt where the next action will be — German bunds. However, since a monetary easing may not be forthcoming in Germany until next spring or mid-1992, near-term appreciation potential may still be somewhat limited. It should be noted, though, that on top of record-rate buying domestically, foreign purchases of German bonds appear to be rising again.

We don't see any foundation for a sustained recovery in any of the Anglo-Saxon countries. The key question that remains is this: When and what will trigger an awakening of the public and financial markets?

If the United States continues to lower interest rates, as seems probable, that implies a progressive strengthening of the D-Mark. In drastic contrast to the consensus view, we expect the dollar to fall towards new all-time lows against European currencies in due time. This also makes us rather pessimistic for stock markets generally . . . especially the grossly overvalued U.S market.

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